

ADDRESS

by

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Washington, D. C.

Before

THE SEVENTY-NINTH ANNUAL MEETING

of the

AMERICAN INSTITUTE

OF

CERTIFIED PUBLIC ACCOUNTANTS

Sheraton Boston Hotel
Boston, Massachusetts

October 5, 1966

We have known each other for a long time, but this is my first appearance before you on your home grounds. I am, therefore, particularly happy to have this opportunity to speak to you about work in progress, of our hopes for future development and our need for continued cooperation as we strive for more effective discharge of our duties. At the outset I wish to express my appreciation for your efforts over a generation in the improvement of financial reporting as well as for your visits to us as individuals and in committees.

In its administration of the federal securities laws, each of which recognizes the essential character of adequate record keeping, full disclosure in financial reporting and the significant role of the independent public accountant, the Commission has benefited by your work and the advice and assistance you have given us. This has been so even though we have not always been in full agreement on the best course of action in our joint ventures. We do, however, share a number of things in common. Most important of these is a mutual concern to identify financial reporting practices which may be misleading to the investor and to insist upon their elimination. In this effort you and we operate in the full glare of publicity and become the targets of all who differ with our views concerning fair financial reporting. Our critics are found within the accounting profession, and among university scholars in accounting and economics, financial analysts (both amateur and professional) and the financial press.

It seems appropriate in this light to recall that our joint interest in the administration of the securities acts stems from the acceptance by the Congress of the proposal made by an accountant that the financial statements to be included in registration statements required by the Securities Act of 1933 be examined by an independent public accountant who should express his opinion with respect to those statements. To many who heard this recommendation it seemed unnecessary and promised to be expensive.

Some of you may recall that this proposal was suggested as an alternative to one then under active consideration -- that the financial statements be reviewed by government auditors. Colonel Carter, as a representative of the accounting profession, was persuasive in his assertion that independent public accountants familiar with their clients' affairs would be able to make the required examinations more quickly and economically than an army of government accountants. Colonel Carter's suggestion was adopted in the Securities Act of 1933 and reaffirmed as Congress added to the structure of Federal legislation concerned with the securities markets and those who do business in them. But the Congress was not content to leave it there. It vested the Commission with the broadest possible authority -- and consequently the responsibility -- to define accounting terms used in these statutes and to prescribe the forms and methods to be followed in presenting financial information. From the beginning, the Commission has, in the main however, held that authority in reserve, in the expectation that the independent accountants would actively exercise the initiative they had sought and secured. With some exceptions, our expectations have been realized. To the extent that the profession has been willing to move ahead, we have been content to remain watchfully in the background, filling a vacuum when necessary and stimulating study and development of accounting and auditing principles on a continuing basis.

I am certain that you have often heard from representatives of the Commission that the role of the accountant is vital to the effective functioning of the federal securities laws. It is also no news to you that we consider the continued cooperation between the profession and the Commission necessary in achieving effective, meaningful and full disclosure in financial statements and in other material filed with the Commission. As I have stated elsewhere, you represent one of the self-regulatory bodies which, though not endowed with any specific statutory authority, have contributed so much to our unique form of cooperative regulation in the public interest. In substantial measure, this has been due to the statutory insistence that the public accountant entrusted with such important responsibility be completely independent. It is a truism, but no less significant, to note that the integrity and completeness of the required financial statements are the keystone around which is built the kind of investor confidence which supports our capital markets. In recognition of this grave responsibility, we have both expended considerable effort to define and implement this requirement of independence. It may, therefore, be appropriate for me to refer to the doubts now being raised in some quarters about the independence of the accountant who provides his audit clients with what is loosely called "management services."

A recent book by Eric Kohler, an accountant well known to all of you, notes that "A public accountant's established services to management have also come to be of the first order of importance. These include the preparation of income-tax returns, or aid in their preparation or review; and forward planning on such diversified matters as budgetary procedures, costing methods, inventory controls, incentive plans, and pension schemes." These services may, in Mr. Kohler's words, be "natural consequences of the auditor's developed skills," and may "contribute to a better background for succeeding audits, as well as to better management." So long as they are directed toward those ends, they do not appear to pose a serious threat to the accountant's independent status.

However, a word of caution is in order with respect to what one of your prominent members describes as "consulting services which cannot be related logically either to the financial process or to broadly defined information and control systems, [such as] market surveys, factory layout, psychological testing, or public opinion polls." And, I am disposed to add, executive recruitment for a fee. An accountant who directs or assists in programs of this kind raises serious questions concerning his independence when it comes time to render to creditors, to investors and to the public his opinion on the results of the programs. Public accountants should carefully reconsider their participation in these activities lest their continuation and extension undermine the main function of the independent accountant -- auditing and the rendering of opinions on financial statements. On the other hand, the notion seems to persist in some quarters that an auditor's opinion amounts to nothing more than attesting to the arithmetic in the books. Those who share this view fail to recognize that the basis of the auditor's opinion is found in adequate records, properly maintained and supported by internal checks and controls which include administrative practices as well as the recording process.

Good record keeping and internal controls are important not only to accountants in forming the bases for good financial reporting; they are also important to us in connection with our regulatory and enforcement work and in our internal housekeeping. You know, perhaps better than we, the increasingly important, and the new, roles computers are playing in so many areas of our daily activities. You may be interested in the steps the Commission is taking to modernize and improve its procedures. When we moved into our new building, we installed a computer designed to do many of our old chores faster than we could do them by hand and to enable us to do many new jobs which previously were not feasible. Our internal accounting and statistical work have been transferred to the new equipment, as well as other chores which required laborious manual checking of many files and indices.

We are also using the computer in expanded over-the-counter market surveillance; we are adapting it to our studies of quarterly financial reports, corporate pension funds, broker-dealer reports, selected financial data for larger registrants, off-floor trading by stock exchange members, and other matters. We have in mind future application of the computer to Form N-1R reports by investment companies, to ownership reports, legal and accounting research, financial reports of broker-dealers and investment advisers, and to our mailing lists. We are also pressing the stock exchanges and the National Association of Securities Dealers to further the development of automated procedures in their respective markets which will be compatible with our own automated procedures and which will enable us to establish a cooperative surveillance program superior to any that has hitherto been possible -- one which may, perhaps, be available to all properly concerned with such matters.

Your President's invitation encouraged me to speak as strongly as I like on any matter on my mind. This prompts me to say a word or two about auditing. It is here that your reputation, and sometimes your pocketbook, is at stake.

Five years ago, during what is frequently referred to as the "hot issue" period, many prospective registrants faced the necessity of improving their accounting and operating procedures before the independent accountant could certify their financial statements. This situation was not confined to new companies in which record keeping had lagged behind phenomenal growth; we found some established companies in which the reviewing accountants could not provide the opinions necessary to meet registration requirements.

Some of you may recall that the chairman and other members of your auditing committee went to Washington on a stormy Washington's birthday in 1962 to help our Chief Accountant draft a release on the certification of income statements. After observing a parade of qualified accountants' opinions covering first time audits, the Commission decided that the time had come to do something about it. This release seemed to have an immediate salutary effect.

However, similar conditions came to light again with the passage of the 1964 amendments to the securities acts. Inventories and receivables continue to be the root of many of our difficult cases. In others, the trouble is in

unaudited interim periods. Gross discrepancies discovered after publication of the interim figures have cast suspicion not only on those results but the published results for prior periods.

Our investigations often leave us with a feeling that each generation of auditors learns only by its own sad experiences rather than from earlier cases. We wonder whether auditors sometimes forget that a basic qualification of their calling is that they have a healthy skepticism and look at the business operation as a whole rather than as a series of isolated technical questions. We realize that hindsight is clearer than foresight, but many of the cases we see cannot be brushed aside with this explanation. In some recent situations we were compelled to note incompetence, lack of supervision, disregard of recognized auditing standards and procedures, and a too-willing acceptance of management's opinions. These situations, although few in number, make the headlines and cast doubt on the value of the work done in the majority of audits where the investor's interests have been served in the manner contemplated by the securities acts.

I imagine most of you have read -- or at least heard about -- my talk to the Financial Analysts Federation in May, so I shall not repeat what I said on that occasion. I do want to repeat, however, that I believe the highest priority should be given to the elimination of unsound practices and unjustified variances in financial reporting. We are aware that your Accounting Principles Board expects to publish its opinion on pensions shortly and is pressing hard to complete studies on important subjects including inter-period allocation of corporate income taxes, accounting for research and development, inter-corporate investments, and sundry other matters. But when a change by a rapidly expanding new business in its methods of accounting for development expenses and depreciation from one "acceptable" and "conservative" method to another results in a small profit rather than in a substantial loss, it is obvious that a good deal of work remains to be done before "generally accepted accounting principles" command the degree of public confidence we would all like them to have.

Let me add a word at this point about accountants' responsibility. Accountants owe important duties to their clients, but they also have an overriding responsibility to society to see that their efforts on behalf of their clients are not inconsistent with the public interest. Accountants occupy a place of importance and honor in this country. But, as one of your outspoken brethren has pointed out, you will continue to occupy that position only so long as you serve the interest, and can claim the confidence, of the public. I am sure these precepts will continue to influence your deliberations on the important questions before you. If all of this rings of an often-heard cliché, it should not lose its significance simply because it is familiar to you.

It is only fair to acknowledge, here and now, that the members of the accounting profession have long recognized their responsibility to the public. In 1900, a leading accountant wrote that "a public accountant acknowledges no master but the public . . . A public accountant's certificate, though addressed

to the president or directors, is virtually made to the public, who are actually or prospectively shareholders. He should have ability, varied experience, and undoubted integrity."

The role of the independent accountant in developing and improving standards of financial disclosure is so important that I should like to re-emphasize some points I made to another group of accountants at a meeting two years ago. I hope you will forgive me for repeating myself, but the experience of the past two years, particularly with companies that have become subject to the reporting requirements of the securities acts for the first time, emphasizes the importance of the subject.

Because of his special status and responsibility, the accountant has a unique opportunity to be a leader in raising standards of investor protection. The "financials" provide the key information both in the distribution and trading of securities. The work of the accountant in their preparation and publication is vital. Independent accountants lend authority to management's representations by their opinions as experts, and they operate as a check on management in assuring that the financial data are fairly presented in accordance with generally accepted accounting principles. In performing this function, the accountant should not be satisfied when he has done just enough to answer affirmatively the question, "Will this get past the SEC?" The standards prescribed by law are a bare minimum. The independent, as well as the internal, accountant should be guided by the question, "What do the investors, and the professionals who bear a heavy responsibility in recommending or selling securities, need to know to make an informed decision about this or that issuer?"

I think you will recognize that I have not outlined anything new for the accounting profession; the Commission seeks merely a continuance and furtherance of what it always has sought -- and most often received -- from the profession.

All of you must now be aware of our interest in more detailed financial reporting by conglomerate companies; that is, those widely diversified companies whose operations include a number of distinct lines of businesses or classes of products or services. The effect of diversification has been, at times, to obscure financial information which may be important to sound analysis of the company's worth. Early in the summer, your Committee on Relations with the SEC and Stock Exchanges, because of the urgency of other projects on the Accounting Principles Board's agenda, was assigned the duty of studying this problem with us. This committee -- perhaps it should be renamed the Conglomerate Committee, as its chairman has suggested -- has met with our staff and with a committee of the Financial Analysts Federation and other organizations. Financial executives, individually and in committees, have also conferred with you and with us on the subject. In fact, representatives of the Financial Executives Institute appeared before the Commission last Friday to outline their plans to study and make recommendations on this subject. They impressed us greatly with the affirmative and energetic nature of their approach and their readiness to provide the money and personnel necessary to expedite the matter.

We appreciate all of these efforts to assist us in defining and refining the issues involved. However, I must admit that some of the initial presentations to us do not communicate the sense of urgency which I believe should pervade our discussions. Every week we read of new acquisitions and combinations of companies in very different lines of business. Whether it is an office equipment maker acquiring a producer of housewares and industrial equipment, or an auto parts company acquiring a mining and smelting company -- to cite two recent examples -- the problem is the same. Where investors, and those professionals to whom I have alluded and who play such an important role in our scheme of things, formerly had separate financial statements which gave more or less meaningful pictures of different operations, they may now receive figures which will tell them very little about anything. As independent accountants, it is your function to be active and imaginative in seeking solutions to difficult problems. You should not necessarily be deterred by objections to what may appear to some to be "unnecessary" or "expensive" disclosure. (You will recall that these are the same words I used earlier in referring to the 1933 opposition to the requirement of certification by independent public accountants.)

In your communications to us, you have quite properly emphasized the difficulties of obtaining adequate information and the importance of being sure that published breakdowns of profit, or contributions to profit, by different lines of business not contain any misleading or unsupported figures. However, there is another side of the question to which I hope you will address your attention, and that is the inadequacies of the present system under which too many conglomerate companies make no disclosure at all concerning the relative profitability or unprofitability of their various divisions.

Under our rules, a company engaged in the production or distribution of different kinds of products or the rendering of different kinds of services must indicate, insofar as practicable, the relative importance of each product or service or class of similar products or services which contributed 15 percent or more to the gross volume of its business. Let us assume that a company is engaged in two distinct lines of business, each of which accounted for about half of its volume in a particular year, and that this fact is disclosed in the prospectus or report that the company files with us. However, all, or substantially all, of the company's net income was derived from one of these two lines. I am not sure that financial statements which do no more than report sales, cost of sales, expenses and net income for the two divisions combined, "fairly present" the results of operations of the company for that year. When the figures published in the income statement combine the results of operations in different lines of business in which gross profit margins and net income differ sharply, they may be inadequate to convey meaningful information about the manner in which the company derives its income and may be more misleading than any of the alternative ways in which the divisional breakdown might be presented. In exploring and evaluating a new way of doing things, we should not overlook the fact that, in some areas at least, the weaknesses of the present system may outweigh the dangers of the proposed one.

In raising these questions about conglomerate companies I do not wish to detract in any way from the importance that we attach to the publication of consolidated statements for a corporation and its subsidiaries. The development of consolidated statements as the appropriate method for presenting the

financial position and results of operation of a group of affiliated companies was an important victory for the investing public after a long and difficult struggle. The problem of conglomerates is a newer one; it is the other side of the coin. An increasing number of companies and groups of affiliated companies are spreading themselves over a variety of entirely different kinds of operations, and it is no longer enough for the investing public to know the overall results in consolidated form. If investors are to make meaningful decisions, they must also know the respective contributions of these various categories to the consolidated income figures.

There is also another aspect I would like you to bear in mind. There seems to be a feeling in some quarters that the only people who have any interest in obtaining this information or could use it effectively are the financial analysts, whose appetite for financial information is considered to be virtually insatiable. I do not think this is a valid criticism. In the first place, some sort of divisional breakdown may make it easier for the relatively unsophisticated investor to judge the merits of a particular company. In the second place, disclosure of this kind of information, like all disclosures under the securities acts, serves a number of purposes. It not only informs the investor or his adviser but also serves as an important control on corporate managers by requiring them to justify the results of their stewardship. There may be diversified companies which are maintaining low-profit or money-losing operations for reasons which would not be persuasive to stockholders or financial analysts, and requiring separate disclosure might well result in the improvement or elimination of the sub-standard operation, to the ultimate benefit of the stockholders and of the economy generally. Finally, we may well find, as we have in other areas, that a requirement of public disclosure will result in improvements in internal accounting procedures that will provide the company managements themselves with more useful information to evaluate the performance of their various divisions.

On the other hand, as I told the Senate Subcommittee on Antitrust and Monopoly in my testimony last month, we are not dealing with two distinct classes of "conglomerate companies" and "single product companies." In some companies, the various operations may have so little connection with one another that there is no problem in drawing the lines. In other companies, however, the lines may be unclear. This means that for the truly "conglomerate" companies at one end of the spectrum, it may be possible to develop meaningful disclosure requirements without much further study. However, as we move along the spectrum toward companies with greater degrees of integration in their operations, the problems become increasingly difficult. We shall solicit your active cooperation, and that of others concerned, in arriving at appropriate answers.

As I said at the beginning of my talk, Congress in 1933 decided to give the members of the accounting profession the opportunity to take the initiative in developing and improving standards of financial reporting. Members of the Commission have from time to time expressed uneasiness whether the initiative shown by accountants corresponded adequately with their abilities in this area.

However, I am pleased with the rate of progress you have maintained in recent months, particularly as it relates to the elimination of unnecessary variations in accounting. I hope that the same attitude will be applied to your work on conglomerate companies and other current problems, and that you will continue to fulfil your obligations to the public in such a way that we will not be required to consider the need for us to fill a gap.

Let me emphasize again, in closing, that Congress gave us the final responsibility for insuring that adequate standards of disclosure are maintained, and it is a responsibility that we take very seriously. However, we prefer -- and I anticipate that the Commission will always prefer -- to accomplish these objectives through cooperation as long as we are persuaded that it is an effective and expeditious way to achieve them.